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Government worries about gas prices, ignores the sector

Rapid changes on the Ukrainian gas market require that the Government develop a new policy. Since 1 January 2006, the natural gas market has taken new shape, yet neither the Ukrainian government, nor market operators appeared ready for this change. Today, the conditions under which this market operates are determined, not by interstate agreements, but by the policies of private gas companies. Without a clear government policy in this area, there is a serious risk that these companies will abuse their monopolist position, setting inappropriate prices and distributing resources ineffectively

The development of the Ukrainian gas market has attracted the close attention of the media, the public, Government officials, and politicians. However, their comments on market events are frequently one-sided and contradictory. As a result, there is no proper picture of the situation on the gas market. In order to open debate with all market participants on options for the developing the Ukrainian gas market, the Management Through Public Discourse Agency and the International Centre for Policy Studies held a roundtable called "Rethinking the Ukrainian Gas Market: New challenges and prospects" on 16 October 2006.

Participants in this discussion included representatives of central executive bodies, the Office of the Verkhovna Rada and business, academics, independent experts, and journalists. The positions of interest groups were presented by Roman Storozhev, president of Gas Traders of Ukraine, an association; Yuriy Shulha, Deputy Chair of the Department for Energy Security at the National Security Council; Andriy Chabanenko, manager for commercial gas supplies, TOV MetInvest Holding; Leonid Unihovskiy, general director of TOV NaftoGazBudInformatyka; and Ihor Lutsenko, economics editor of *Ukrayinska Pravda*, an internet publication.

The experts talk prices and visions

According to **Roman Storozhev,** the reshaping of Ukraine's gas market has exacerbated long-standing problems of this market, especially the lack of a transparent and economically justified mechanism for setting prices and rates and the flawed legislation governing this sector. Mr. Storozhev said that cross-subsidies for residential and budget-funded consumers complicated cooperation between independent gas traders and other market participants, such as the centralized heating plants. According to Mr. Storozhev, it is impossible to bring domestic gas prices to market levels without competition and spare gas stocks, so the number of gas importers has to grow.

Andriy Chabanenko stressed that, for the metal industry, stable and guaranteed supplies of gas were equally important to gas prices. At the moment, though, said Mr. Chabanenko, business cannot predict what will happen with gas prices. Agreeing that competition might reduce prices, Mr. Chabanenko said that there was very little likelihood that an alternative to the current partnership between RosUkrEnergo and UkrGaz-Energo might emerge any time soon because the current situation was very convenient for GazProm.

In the opinion of **Yuriy Shulha,** to improve the situation on the gas market, the Ukrainian Government must: (1) arrange gas deliveries with Russia, Turkmenistan and Kazakhstan; (2) update current energy resources; (3) increase in-country gas extraction; and (4) stimulate energy-saving. Mr. Shulha also said that domestic price rises for gas should be gradual in order to mitigate the shock to the country's economy and the general population.

Leonid Unihovskiy emphasized the need to adopt the Bill "On the gas market" already in 2006. Mr. Unihovskiy, all five versions of this bill that are currently in the Verkhovna Rada need to be reworked, as they do not specify the rights and responsibilities of market participants and do not identify mechanisms for the gas market to operate. As an example of possible changes in the future, Mr. Unihovskiy proposed setting up exchanges or electronic platforms for selling gas, which would make it possible to involve new gas suppliers. He also mentioned that, despite problems in the work of NAK NaftoGaz Ukrainy, this company was critical to the market and its success would largely determine the development of the market.

Another expert, **Ihor Lutsenko,** was convinced that the problem was that the state was an inefficient owner whose activity on the gas market was leading to losses for the domestic economy. Thus, according to Mr. Lutsenko, inefficient management of NAK NaftoGaz Ukrainy resulted in the government losing the market of industrial gas consumers and the possibility to make direct purchases of Turkmen gas. Mr. Lutsenko thinks that it makes sense to privatize assets in this sector and to liberalize the gas market as much as possible. He also recommended businesses to form an association of large gas consumers in order to become a gas buyer equal to NAK NaftoGaz Ukrainy and to defend their interests more effectively.

The Government must do its homework

Summing up the results of this roundtable, one of the main problems in this sector is clearly the lack of a long-term vision of the country's gas market on the part of the Government itself. The Government needs to develop such a vision, as businesses are interested only in the final policy results: the price for gas and conditions for buying and selling gas.

Yet, liberalization at this stage of development will not result in any short-term reduction of prices on the Ukrainian gas market. However, the replacement of the state monopoly with a private monopoly will make it necessary to improve state regulation to protect interests of all stakeholders, suppliers and consumers alike.

Unfortunately, officials from the energy ministry, NAK NaftoGaz Ukrainy and other state-owned companies in this sector chose to ignore the invitation to this roundtable. As a result, they failed to hear the opinions of other stakeholders on government policy on the gas market. At the same time, the Government's position remained unclear to those at roundtable. ■

For additional information on this topic, please contact ICPS economist Ildar Gazizullin by telephone at (380-44) 484-4400 or via e-mail at igazizullin@icps.kiev.ua.

Economic forecast for Kompanyon

On 27 October 2006, Kompanyon, a Ukrainian business journal, published a special project: a forecast for the development of the main sectors of the economy for 2007. This is the third time in a row that the International Centre for Policy Studies has carried out this assignment for this analytical publication, whose main goal is to increase the quality of business decisions

In 2007, Ukraine's economic growth will be driven by domestic demand. The highest growth will be registered on the investment market, whose capacity will grow 10% in real terms. Rapid growth of domestic consumption, prospects for exports and higher energy prices will stimulate companies to begin upgrading and expanding production capacities.

The financial sector will be especially attractive, in particular non-banking financial institutions, as will be the consumer sector, retail trade, real estate, and machine-building.

Media business could show serious growth in 2007. Last year, the media market grew 66%, while revenues over January–August 2006 alone were US $3bn. There are also significant prospects for advertising: this sector has shown stable annual growth at 30% and could rise to nearly US $1.5bn in 2007. Information technologies continue to be among the top five performers, and the arrival of major international IT players is expected over the next year.

Tourism is also growing at a brisk pace: over H1'06, the number of Ukrainian tourists almost doubled. However, Ukraine is not yet a serious tourist destination for foreigners due to the lack of quality infrastructure and effective advertising to promote Ukrainian attractions.

The most rapid growth is being registered in the banking sector, where total growth of investment was UAH 67bn over the first nine months of 2006. High demand for loans will persist throughout 2007 as well. The share of foreign capital in the Ukrainian financial sector, currently 22%, will rise.

Unfortunately, the growth of specific sectors is not improving the overall image of the Ukrainian economy on global markets. This year, Ukraine lost 10 positions in global competitive ratings, falling to 78th place out of 125 countries. Even if the situation stabilizes, further economic growth is hanging by a thread. The main problem is that the country does not have a single reliable internal long-term growth factor. ■

For the complete forecast, read Kompanyon, Issue №43 (507) of 27 October 2006.

Sectors rated by growth potential

Forecast for 2007			Forecast for 2006		
Item No	Sector	Growth forecast	Item No	Sector	Growth forecast
1	Banks	53%	1	Audit and consulting	40%
2	Media business	51%	2	Advertisement	35%
3	Advertisement	37.5%	3	Banks	31%
4	IT	26%	4	IT	30%
5	Tourism	20%	5	Car-making	30%
6	Audit and consulting	20%	6	Insurance	20%
7	Car-making	15.8%	7	Tourism	15.5%
8	Retail trade	13%	8	Machine-building	14%
9	Pharmaceutics	12%	9	Retail trade	13%
10	Machine-building	8%	10	Food industry	8%

Overly restrictive grain export quotas will cost business

An 11 October 2006 Cabinet Resolution has instituted an overall 1.6mn tonne export quota on all kinds of grain until the end of the year. With this quota, the Government is trying to limit the export of grain in order to supply the domestic market. This year, world grain prices have jumped considerably because of a poor worldwide harvest and reduced grain reserves. As a result, it is currently more convenient to export wheat then to sell it internally on the Ukrainian market. For instance, DerzhReserv purchasing prices for 3rd grade wheat are UAH 775–800/t and 4th grade is UAH 675–680/t, while the price for wheat under futures contracts signed 9 October 2006 for December 2006 delivery on US commodity exchanges was US $181.60–195.60/t.

Ukraine has already sold nearly 5.5mn tonnes for export from this year's crop. The total potential for grain exports in this marketing year is 9–11mn t according to different estimates. According to Ms. Akhtyrko, the quota set by the Government is too low—even if it were twice as high, it would not lead to any shortages on the domestic grain market.

In choosing between giving grain exporters the advantage and protecting the domestic market, the Government tends to support the latter. The lack of limits on exports could push domestic prices up, or to a possible shortage of grain. Should domestic grain prices go up, it would cause baked goods and feed for poultry and livestock to also go up, which would cause a chain reaction in prices for a slew of foodstuffs. Should there be a shortage, Ukraine will be forced to import grain in the middle or at the end of the marketing year for prices that will likely be higher than current domestic prices.

The overly small volumes of exports, based on the current quota, will likely cause an oversupply on the domestic market, putting downward pressure on domestic purchase prices for grain. Even if the quota is removed next year, world prices are likely to be lower at that point than they are currently. Thus, placing severe restrictions on grain exports will cause losses not only for grain traders but for Ukraine's grain growers as well. According to the ICPS economist, a more effective decision would be to set the quota at around 4mn t until the end of the current marketing year, June 2007. This would allow grain traders more options when purchasing.

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